Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:TL-N-6908-00
[redacted]

date: December 6, 2000

to: Examination Division, Senior Team Coordinator [redacted]

from: Area Counsel, [redacted]

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subject: **Original Issue Discount on a Delayed Delivery Contract I.R.C. §§ 1272 to 1275 and 811**

[redacted]

You have requested advice with regard to whether the taxpayer must report original issue discount (OID) income or other income in connection with the purchase of government bonds where delivery of the bonds is to be made ten years after the purchase.

Specifically, the [redacted] (the taxpayer) entered into a contract with [redacted]. Under this contract, the taxpayer agreed to pay (and did pay) $[redacted] to [redacted] on [redacted]. In return, [redacted] agreed to deliver to the taxpayer on [redacted] United States Treasury Bonds that were issued on [redacted]. The face amount and redemption value of the bonds is $[redacted]. The issue price of the bonds is slightly less than that amount. The bonds are due and payable by the United States Treasury at face value on [redacted]. The bonds bear coupons for periodic payments of interest at [redacted]%. The bonds are to be delivered on [redacted] without the coupons payable on dates before the delivery date ("coupon stripped") but with the coupons payable after that date.

The taxpayer also entered into a similar agreement with a [redacted] bank. In that case, the payment by the taxpayer was $[redacted] on [redacted], to take delivery of United States Treasury Bonds on [redacted]. The bonds have a face value of $[redacted], a maturity date of [redacted], and a stated interest rate of [redacted]%.

Both of the above bond purchases appear to have been arms-length transactions between financially sophisticated parties.

The Examination Division is currently examining the taxpayer's return for [redacted]. The [redacted] return does not report any interest income or other income as a result of the above transactions.

Law

I.R.C. § 1272(a)(1) states:

> For purposes of this title, there shall be included in the gross income of the holder of any debt instrument having original issue discount issued after July 1, 1982, an amount equal to the sum of the daily portions of the original issue discount for each day during the taxable year on which such holder held such debt instrument.

I.R.C. § 1272(a)(3) defines "daily portions" as depending on the adjusted issue price, the yield to maturity, and the accrual period. The accrual period depends on the date of original issue and the maturity date.

I.R.C. § 1272(c) states that "this section" [§ 1272] shall not apply to a holder "which is a life insurance company to which section 811(b) applies."

I.R.C. §§ 801 through 848 apply only to insurance companies.

I.R.C. § 811(b)(1) provides that insurance company income

> shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount attributable to the taxable year on bonds . . . held by a life insurance company. Such amortization and accrual shall be determined--
>
> (A) in accordance with the method regularly employed by such company, if such method is reasonable, and
> (B) in all other cases, in accordance with regulations prescribed by the Secretary.

I.R.C. § 811(b)(3) provides an exception to § 811(b)(1). It states that "no accrual of discount shall be required under paragraph (b)(1) on any bond . . . except in the case of discount which is--

> (A) interest to which section 103 applies, or
> (B) original issue discount (as defined in section 1273).

I.R.C. § 1273(a) states:

> For purposes of this subpart--
> (1) the term "original issue discount" means the excess (if any) of--
> (A) the stated redemption price at maturity, over
> (B) the issue price.
>
> (2) The term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time (other than any interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument).

Issue

Must the taxpayer report original issue discount income or some other income in its [redacted] return as the result of its U.S. Treasury bond transactions with [redacted] and the [redacted] bank?

Analysis

The transactions entered into by the taxpayer appear to have put it in the same economic position as if it had purchased a ten-year original issue discount bond while avoiding the purview of I.R.C. § 1273. The taxpayer has invested $[redacted] dollars. At the end of [redacted] years, it will receive bonds that are worth considerably more than that. It will receive no periodic payments of interest during the [redacted] years. The receipt of the bonds at the end of [redacted] years will return the taxpayer's $[redacted] principal to it and any excess will compensate it for the use of its money, i.e. will be interest. From the economic point of view, this is similar to a [redacted]-year original issue discount bond. As the underlying bonds in question are coupon-bearing

Treasury bonds, however, with redemption value and issue price which are nearly the same, the transaction does not clearly satisfy the definitions for original issue discount laid down in I.R.C. § 1273.

In a meeting held on December 5, 2000, with [redacted] and [redacted] (all of the Exam Division) and [redacted] of Chief Counsel, it was agreed that this issue requires further development. It appears that a "substance over form" argument may require the taxpayer to accrue the interest and report it in income tax returns during each of the [redacted] years commencing in [redacted]. It is also apparent, however, that such a challenge to the taxpayer's return would require extensive and time-consuming involvement by the Office of Chief Counsel.

You wish to complete this cycle of this taxpayer's examination within a week. Under these circumstances, we do not recommend challenging the taxpayer's treatment of this item in its [redacted] return. We strongly urge you to raise this issue early in your examination of the taxpayer's [redacted] return. At that time, a request for technical advice or field service advice can be implemented. With the full input of the Chief Counsel's Office, we believe that an appropriate litigating position can be developed on this important and interesting issue.

If you have any questions, please contact the undersigned attorney at [redacted].

[redacted]
Associate Area Counsel

By: [redacted]
Attorney

cc: Associate Chief Counsel, Procedure and Administration, Technical Services Section